12 December 2017

Dear All,

We hope you are keeping well and are looking forward to the upcoming holidays. The lights are up in London, but we feel busier than ever as unusual situations seem to always develop when people leave for the break. Thank you as well for your excellent feedback from the first letter which sparked some very enjoyable discussions, particularly surrounding serviced office impact across office markets. This second letter follows up on some of these trends and adds one or two new elements that we are tracking. We hope you enjoy reading and certainly encourage you to reach out with any thoughts you may have.

Net Absorption, Huh?

We recently read with some amusement and amazement an article in a UK property industry magazine, using research contributed by a UK property company, about a new way we should all be looking at office demand: net absorption. The article stated that "London's occupiers have vacated the greatest amount of space in 15 years" as "[n]et stock absorption, which is the difference between occupied space from one period to the next, fell to [negative] 3m [square feet] in 2016 – below the [negative] 1.5m [square feet] experienced in 2008. The first half of 2017 saw a further [negative] 800,000 [square feet] of losses."

Amused, because a trade journal had to spend time defining the only meaningful way to measure office demand, which it seems much of the rest of the world understands. But we were amazed because we have been sharing this information with our investors for a while, including in our last annual meeting, where we stated that recent take-up (which the journal also had to point out "can only ever be a positive number") overstated actual demand because net absorption was negative. We find it odd that this information might be considered "news", considering that it is calculable using CBRE data. Mike thought it sounded like one of those dubious advertisements: "This group added – **and then subtracted** – and the results will astound you!"

But kudos to the property company for bringing this to the attention of the UK market, it's about time! However, we'd go even one step further: this data did not include in this calculation the impact of serviced office take-up. We do not see take-up by serviced office providers like WeWork or The Office Group as positive net absorption, because they simply act as intermediaries to the ultimate space user (i.e. they are simply transferring tenants from one type of building to another). It's actually worse than neutral, because serviced office providers fill the same building with more people than does a tenant that directly leases from the owner.

Restating the data cited above, we believe net absorption after adjusting for serviced office take-up even on a one for one basis (excluding the impact of denser space use than typical office), was negative 4.3 million square feet in 2016 and negative 1.6 million square feet in H1 2017, nearly 2.5 times lower than the level seen in 2008. This is a significant amount of net tenant demand being lost relative to space being added, and we believe this fact is widely misunderstood by the UK agency and investing community.

Attention All Shopping Centres: Is Someone Missing a Valuation?

During the period from 2012-15, we understand that many private equity funds were eager buyers of UK shopping centres, both as part of purchases of larger debt pools following the crisis and because the relatively high yield made for attractive leveraged income returns. While many of those funds have since been successful in achieving their business plans, many others are now finding a particularly unattractive market in which to sell and crystallise their returns.

For example, the owner of the King's Lynn Centre has been reportedly looking for a buyer for most of 2017, and separately we know of one private owner who said he has seen the market clearing price move from somewhere in the 7s to now north of 9% or 10% if he wanted to sell now. This lack of exit liquidity, particularly for secondary assets, is due in part to occupier woes resulting from e-commerce, a sudden realisation that many locations are over-retailed, Brexit (which is of course unique to the UK), and an almost universally standard negative view of shopping centres amongst the investment community.

As a result, many traditional buyers of these high yielding assets are simply no longer interested in buying. This market dynamic makes for an interesting opportunity to try to separate the wheat from the chaff while many investors are "hitting the delete button" as soon as any retail investment email is received.

Furthermore, as many times happens when asset prices fall without immediate distress, volumes are low, so there simply isn't much evidence in the market of current clearing prices. This leads to a curious situation in which retail and other open-ended funds are holding shopping centres on their books at a higher value than what is perhaps justified by the current state of the market, due only to a lack of comparable sales evidence. As market liquidity returns, presumably at lower clearing prices, retail funds could find themselves with an allocation (or time management) issue and begin to trade centers.

We expect there will be an opportunity for the knowledgeable, active investor in the UK market resulting from these dynamics.

Senior Housing Demand Expected to Grow

Not quite the "newsflash", we know, although it is worth putting some numbers behind what we see as an obvious demographic story. In our October note we discussed the shortage of good quality senior housing supply in the UK. In this note we wanted to look at the other side of the equation, comparing the potential demand with the level of supply so as to illustrate in broad terms the structural supply shortage.

There are about 720,000 existing retirement homes in England and Wales that comprise the current stock. For reasons described in our October note, the vast majority of existing stock is outdated and inappropriate relative to the demands of retirees. Relative to this, past studies have indicated that about 25% of older people would be interested in moving to retirement housing, meaning there are about 1.6 million households in England and Wales potentially interested in moving to such housing. So, we are starting from a basis of a material undersupply of retirement housing stock based only on the current population. So far so good.

An even more compelling exercise is looking to the future flow of supply and demand. Looking specifically at England, from 2016-2036, national statistics suggest that there will be, on average, 161,000 new over-65 households each year. Filtering this for people who own their homes with no mortgage and who might be interested in moving to retirement housing gets us to about 39,000 new over-65 households each year that might be interested and financially able to move into retirement housing. Filtering down even further by considering current levels of market penetration of senior housing (i.e. no overall market growth from current low levels), we get to an annual demand of about 13,500 homes per year. Current building levels are only about 7,200 new homes per year, and this includes both affordable (which is the majority) and higher-end housing.

As mentioned, this assumes only the current levels of market penetration in estimating future demand, which we think is a conservative estimate. It is actually a broad expectation that the Government will pass measures to incentivize older people to downsize from their existing homes (e.g., relief from transaction taxes), though we don't know when. Ostensibly, this is a potential way to correct a national problem where older people are over-housed in the family home they purchased decades ago, while the younger population cannot find enough family homes to move into. We understand that both young and old voters support the measure, meaning that retirement living penetration will likely increase as time goes on.

There are great opportunities in this space. While one must be wary of numerous potential pitfalls in planning and design, delivery, and controlling operations, we believe judicious participants can outperform.

The Return of Rescue Capital

We continue to see that UK debt markets are often closed off to smaller, more regional, and, what regulators and the Bank of England have determined to be, higher risk projects (i.e. anything that isn't leased with significant term). That hasn't changed. However, we are now beginning to see an increase in demand for rescue capital on large London projects, as many 2015-16 purchasers seek to complete transitional projects with lower projected returns than originally underwritten. For example, we are aware of an owner in the northern City Fringe looking to refinance existing debt plus fund additional development costs. Having locked in a high basis when making the original purchase and having seen construction costs increase over the past two years, the owner is finding it challenging to obtain all the capital required for the project now that rental expectations have fallen. The owner is in a tough spot, and may be looking to the margin earned on development (either that, or what some funds are now calling the "WeWork Hail Mary" pass) in order to achieve single-digit returns while the incoming lender is going to be looking for a double-digit return for taking one-half to two-thirds the level of risk.

This has created an obvious opening for non-traditional lenders and debt funds. However, this is not a very large market for non-traditional lenders, and the majority of these need to invest large amounts per transaction. Further, many of the debt funds in the market lack the operational capabilities to manage assets if values fall further and the sponsor exits the project. That doesn't matter when rents are on the rise, as it is relatively easy to sell a vacant asset into a rising rental market, but it becomes difficult in the context of needing to complete a development in a falling market with an unmotivated sponsor and no in-house team to do so.

There very well may be an excellent opportunity in the market for a provider of rescue capital with its own asset management team that can work directly or alongside debt providers. Base case returns can be significant and at an acceptable basis if the asset choice is selective, while upside can come from a scenario where the team steps in to the development.

West London… Absolutely Fabulous No More

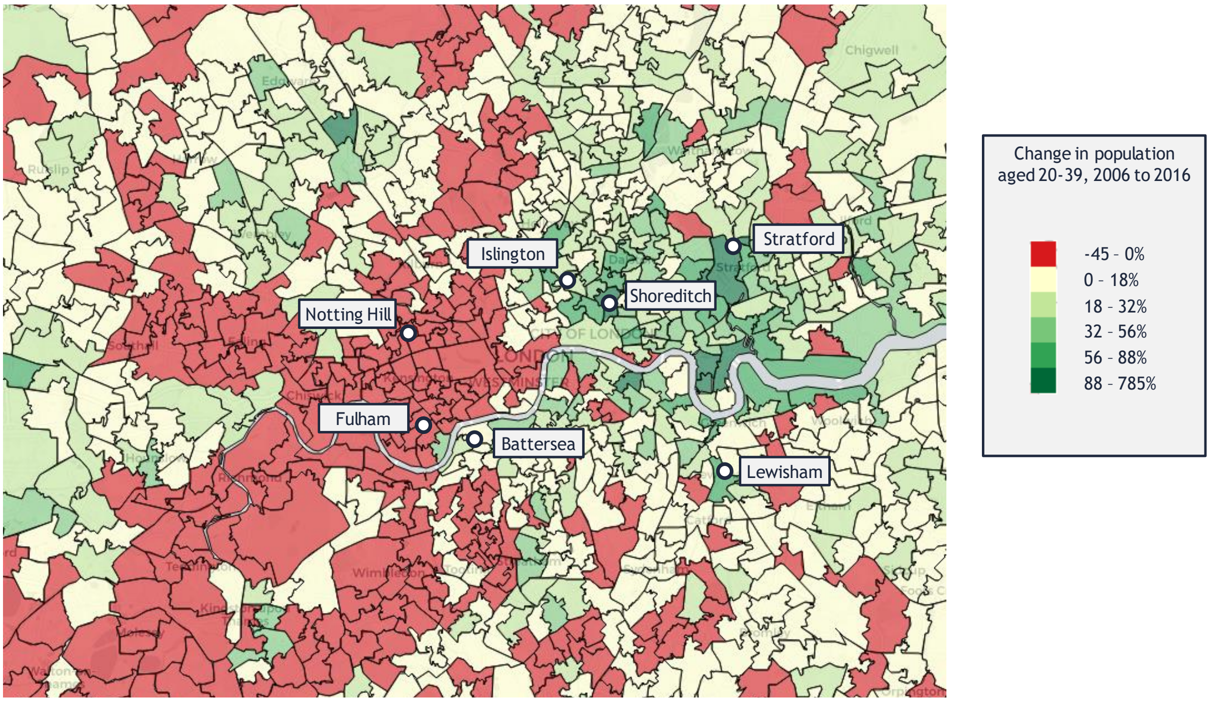
One Sunday, a few weeks back, Mike decided to walk to visit Adam for dinner at his flat in Islington. Over the course of his rambling, two-hour-long trek from our office through Soho, Fitzrovia, Bloomsbury and Clerkenwell, east to Shoreditch, Hoxton and Haggerston, north to Dalston and back west through De Beauvoir Town into Islington, Mike was amazed at the level of development and improvement in the level of both resident quality and retail offer present in the area. In disbelief, he even sent us a photo of a cash machine right next to a public housing estate north of Hoxton Square. Only a few years ago, not only were there no convenient cash machines in the area, but even more you would have been ill advised to have cash in the open in this area.

Where Adam lives would be considered on the border between North and East London, but the area is near some of the most rapidly transforming areas over the past 10 years. Whereas over the past couple years Mike has seen the vibrancy of the area near his home near Holland Park stagnate with ageing residents that have lived in the area for decades supporting only long-established restaurants and shops that can afford high rents (some of which are still shutting down), Adam has seen various restaurants, breweries, bars, pubs, pop-ups, markets and cafés open, filled with young singles, couples and families. In fact, Brandon noted to us that the parents of his childhood next-door neighbour in Kensington still live in their 5 bedroom property, 25 years later and though the kids have moved out, while spending half of their time out of the country. This lifestyle is certainly enviable (and somewhat common to this generation here), but it is also destructive to the vitality of these submarkets.

Further, this generation of owners has little incentive to sell. Unlike the US, the UK has virtually no annual residential property tax but does have a very high and progressive transaction tax known as SDLT as well as Capital Gains tax on sale on second homes, so people are penalised for transactions while having low holding costs. When Brandon's family bought their first house in 1993, SDLT was 1% of the house's purchase price (for anything over £30,000). Today it is 10% over £925,000 and 12% over £1.5 million (which nearly all of these houses are). Therefore buying a new residence costs significantly more upfront, while for sales of second homes, capital gains tax is charged (at up to 28%) on a large profit gained from house price growth over the prior couple decades. Rather than crystallising this tax through a sale, it can make more sense to provide a timely (and tax free in certain circumstances) gift to children or others. So, with minimal holding costs and much higher transaction costs, it is not surprising that the population is ageing in place.

Even the formerly edgy Notting Hill is becoming significantly older: if they were to remake the 90s Hugh Grant movie today about the story of a young bookshop owner, it may well be called "Stoke Newington" or "Clapton". This trend has played out across London: areas in the west have become increasingly unaffordable as older residents remain in their properties and younger residents in London are forced to migrate to the relatively less expensive east and north, bringing with them vibrancy, creative destruction and growth.

Adam put together a more analytical analysis of this shift to the east, which included tracking the movements of the young working population. The choropleth map below illustrates this clearly – there has been a material shift over the past 10 years from the west to the east among 20-39-year-olds. And this begs the question: given the significant shift in where the younger working population lives, what does this mean for where office occupiers choose to locate? Will most industries still prefer the traditionally “creative” West End over the “boring” City office market as the latter provides a significantly better commute and increasingly better amenities? As increasingly large numbers of younger staff demand eastern locations, will decision-makers eventually heed their call or will they act on these preferences as those decision-makers retire? It’s exciting to see how this evolves.



Conclusion

We hope you have found the above interesting and, as always, we welcome any thoughts, comments or feedback you may have so please feel free to reach out. We respectfully ask that you maintain confidentiality and do not forward this letter externally. However, if there are people you feel would like to be added to our list, please let us know and we will be happy to include them. We wish you an enjoyable holiday period and look forward to being in touch again soon.

Best Regards,

Brandon Hollihan | Mike Kovacs | Adam MacLeod

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